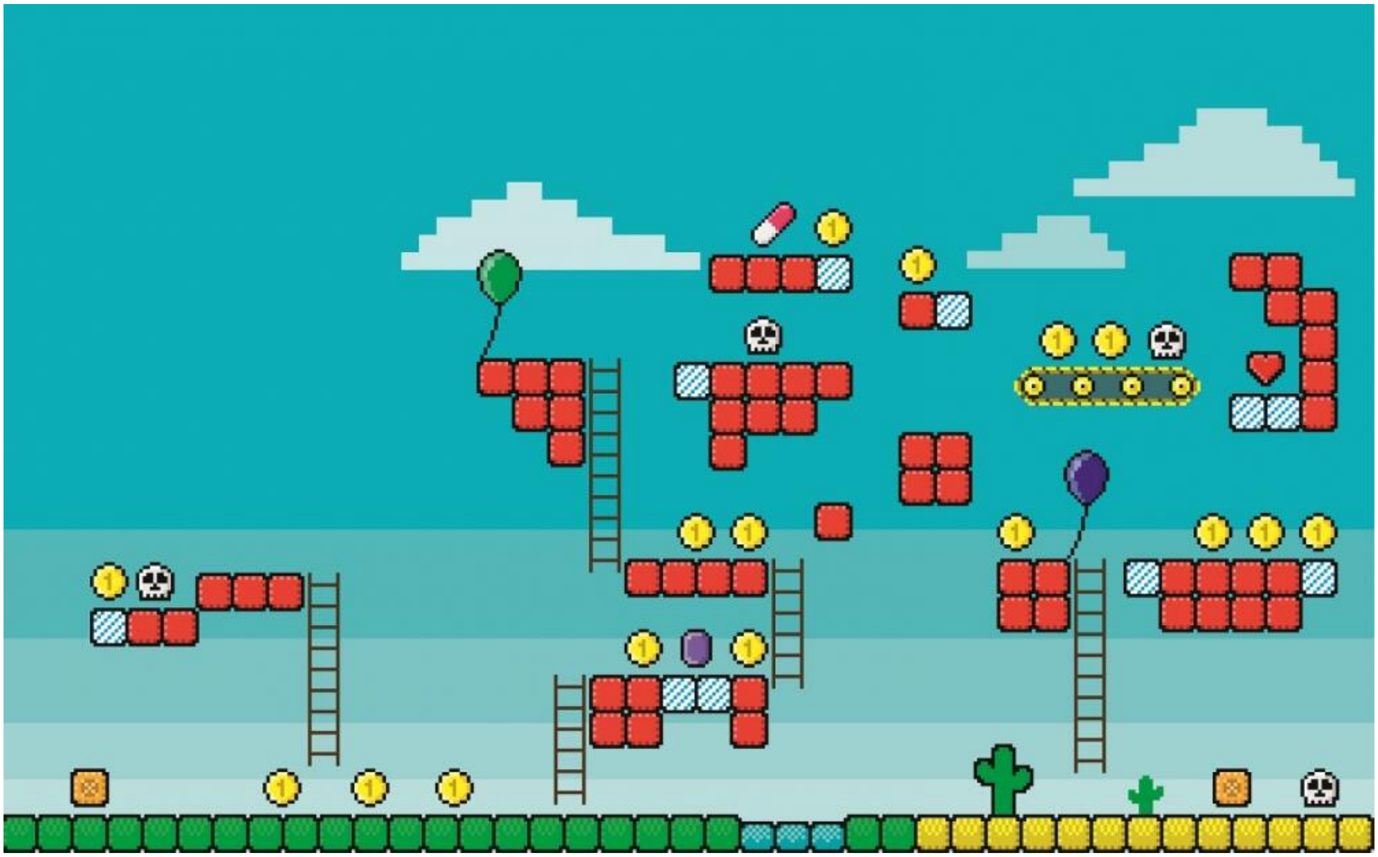
Pressing reset

Large Corporate OMB Personal tax



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Tom Klouda and *Ashley Prior* consider the implementation of an equity reset for underperforming businesses

Key Points

What is the issue?

It is commonplace in the private equity industry and privately held companies for the equity of an underperforming business to be 'reset' as part of a wider plan to incentivise incoming or existing management.

What does it mean to me?

With an equity reset there are a number of tax issues to consider including taxable value shifts.

What can I take away?

Careful implementation of an equity reset is required in order to mitigate the risk of creating tax charges in a business which may already be under performing.

Artificial enhancement of securities

Let us suppose that there is a business which is underperforming. This could be due to any number of factors. For example, there may be material amounts of external and/or shareholder debt which has become unmanageable. On an exit, the debt would typically need to be paid out ahead of any ordinary shares, and in this example we are assuming that the amount of outstanding debt is greater than the value of the company, such that no value would be attributed to the ordinary share capital i.e. the shares are considered to be ‘underwater’.

Taking a step back, an investor may seek to align the interests of management to their own goals. This can be achieved through management acquiring an equity stake in the business, and linking the return that management will receive to key performance metrics for example, achieving a specific exit multiple or IRR on money invested. From a commercial perspective, with no value in the equity, there is little or no incentive for managers to remain with the group, or to grow the business and push it forward (outside of any bonus they may receive).

The solution to the misalignment in goals between investors and managers that an underperforming business can cause is often to reset the equity by capitalising or writing-off shareholder debt, reducing the implicit hurdle in the capital structure. This is by no means the only ‘fix’ but one of the more common ones. A change of the coupon on shareholder debt is also a common route to reincentivise managers and many of the issues discussed in this article arising from a write-off of shareholder debt also apply to a change of coupon.

For example if a business has shareholder debt of £30m with a 10% compounding coupon rate, there is an implicit hurdle each year that must be overcome in order for value to begin to flow to the equity. Let us say that the enterprise value (‘EV’) of the business in question is £18m. Currently on an exit the £18m would all be attributed to the shareholder debt, but the investor is looking at selling in three years’ time. While there is currently no value in the equity, depending on the future performance of the business it may be possible for shares held by managers to participate in the value on an exit. However, in this simplistic approach, in order to participate in any value the managers would need to increase the EV of the business by c.£22m in the three years to the exit just to break even!

If in the example above £10m of the shareholder debt is capitalised, then in the three years to an exit managers would need to increase the EV by c.£9m in order to break even, before beginning to participate in value, which by comparison is much more achievable and more likely to incentivise the management team to perform.

What are the employment related securities tax implications of a reset?

When undertaking any equity reset it is important to consider not only whether it will trigger an employment tax charge at the point of the reset under general principles, but also whether it will result in an artificial enhancement of value under the employment related securities provisions (ITEPA 2003 Part 7 Ch 3B).

Where a proportion of shareholder loan is written off or capitalised, this effectively pushes value into the equity (as outlined above). To the extent that the market value of any securities held by management (which would likely be considered employment related securities) is increased by more than 10% by a ‘non-commercial’ action there may be an income tax charge (ITEPA 2003 s 446L).

The key here is what exactly is considered to be a non-commercial action. A review of HMRC guidance (e.g. HMRC’s employment related securities manual ERSM60030) and case law shows us that this definition is quite wide ranging and can include:

- Anything as part of a scheme intended to avoid tax or national insurance contributions;

- Any transactions between companies which are members of the same group which are conducted on terms which have not been agreed at arm’s length;
- The forfeiture of shares by one shareholder to enhance the value of shares held by an employee; or
- The selective conversion of shares held by an employee, while not converting shares held by another shareholder.

This list is by no means exhaustive but shows that while there may be good business rationale behind why these transactions are being conducted, they may not fall within the commercial exception for the purpose of falling outside of the scope of a charge on artificially enhanced securities.

Where potential tax liabilities are linked to the valuation of the shares it may be prudent to perform a tax valuation in order to demonstrate that any payroll withholding has been conducted on a ‘best estimate’ basis, or that the value has not moved sufficiently to trigger a charge under Chapter 3B.

To the extent the commercial exception cannot be relied upon, Chapter 3B is in point and charges are made in relation to the value of the employment related securities at a given valuation date for a ‘relevant period’. The relevant period is broadly equivalent to the personal tax year running from 6 April to 5 April and the valuation date is the date on which the relevant period ends (usually 5 April).

Charges are triggered where the market value of an employment related security on a valuation date is at least 10% greater than it would have been if there had been no non-commercial increases in the period. The difference between the actual value and the value ignoring the non-commercial increases is then treated as employment income in that tax year. This is reassessed annually for any non-commercial increases in that period only. If the securities are restricted, then the calculation differs slightly to take into account the value of the restrictions.

It is also important to note that where there is a commercial increase in value this could be caught under ITEPA 2003 Part 7 Ch 4 if it is deemed to have not occurred during the normal course of an investment, and employment tax liabilities could apply which can be the case even if the increase in value is less than 10%.

Ok, so we're resetting the equity, what about loan relationships?

Another thing to bear in mind when resetting equity is whether the write off or release of shareholder loans will trigger any charges under the loan relationship provisions (CTA 2009 s 299). A charge to corporation tax may arise where there are non-trade profits in respect of a loan relationship including those arising from 'related transactions'. A related transaction is any disposal or acquisition of rights or obligations under a loan relationship, including the surrender or release of those rights or obligations.

When the borrower company is released from an obligation to pay off shareholder loans (or other borrowings), there is a related transaction and a taxable credit may arise from it. The treatment of the credit depends on the accounting treatment (i.e. where in the accounts it is recognised), the nature of the transaction from which it arises, the status of the company at the time of the release, and the relationship between borrower and lender. A review of the accounting treatment of the loan release is outside the scope of this article.

It is also important to consider whether a formal deed of release is required, to ensure that any relevant debt claims of the shareholder (or other lenders) against the company have been dealt with in a contractually binding way. Otherwise the corporation tax treatment of the transaction may remain uncertain.

Where interest on shareholder loan notes is capitalised, the shares issued in respect of the interest payable on the loan will be 'funding bonds' under CTA 2009 s 413. Under these rules, the issue of shares should be treated as a payment of interest for tax purposes. The amount of payment is the market value of the shares issued, rather than their nominal value or that of the interest liability being discharged. The issuing company must also consider whether it is necessary to retain a portion of the shares (which often presents practical challenges) and account to HMRC for income tax due on the lender's receipt of interest.

Interactions with the Accrued Income Scheme

To the extent that a proportion of the shareholder loan is capitalised as part of an equity reset and the loan balance includes 'rolled up' interest which remains unpaid at the time of the capitalisation, the capitalisation may represent payment, or interest may be chargeable to income tax on the shareholder who is entitled to receive the payment under the accrued income scheme. This is to prevent shareholders receiving capital treatment on interest income which should be subject to income tax charges. A full review of the accrued income scheme is outside of the scope of this article.

Alternatively, if the shareholder loan is also below par value, then it may be more tax efficient to simply pay the (valueless) interest.

Final thoughts

When considering resetting the equity of an underperforming company in order to incentivise the management team and help grow the business going forward, either as part of an ongoing investment, or with a view to an exit, there are a number of interactions with various areas of tax legislation that should be considered. Failure to do so can result in unnecessary tax charges being realised in an already underperforming group.

This article has touched on a few of the considerations to watch out for, but the facts of the transaction should be considered on a case by case basis in order to minimise any potential tax leakage.